An Investor Guide to Inflation

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Keith: Welcome to The Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host, Marcelo Taboada. Marcelo, how are you today?

Marcelo: Keith, I'm so excited. It's going to be a good show. I'm great.

Keith: Yes. In today's show, we are going to be talking about inflation. We're going to try to provide our perspective around this topic that's hitting the newspapers and that most of our listeners, or all of our listeners, are experiencing in their daily lives. So we're going to go through and highlight where inflation's at, what the problem is, how we've gotten here, why it's an issue, and why we should be concerned about inflation. We'll also discuss what the marketplace is trying to figure out—whether this is transitory or whether it's more permanent. And then finally, Marcelo, we're going to highlight some of the implications of rising inflation and what that means for individuals, either on the revenue side, their portfolio side, or just living life in general. That's what we're going to try to cover off. Marcelo, let's start with what's going on with inflation. Why don't you give us an update?

Marcelo: Numbers came out recently, and I can't say I wasn't surprised, but I think the numbers are high, and it's causing some concern in people, especially because we're feeling it in our day-to-day lives. We'll talk about that later, but the U.S. came in at 5.4%, and Canada came up at 4.4% year over year. So that's significantly higher from the target that the central banks have, which is usually between 1 and 3%.

Keith: Yeah, that's right. And really, in the last 10 years for sure, we've had inflation hover between 1 and 2%. So this is a big jump this year over year. What are the specific areas inside the economy that seem to be driving the inflation, Marcelo? What do the statistics show?

Marcelo: The bigger drivers are cars, so that's gone up 7.2%. New home construction materials, so that would be wood, tiles, anything to build new homes. Maybe even renovations—that's up 14.4%. Food is up 4%, and shelter is up 4.8%.

Keith: Yeah, so these are all material jumps that we're seeing. And this is, of course, coming out of the pandemic environment. I say "out," the economies are opening up, societies are moving forward. And this is the big push on all of these different consumer items, for sure. What about gas, Marcelo? That's a big one that everybody notices right away.

Marcelo: Yeah. Gas is up 33% over the five-year average. I felt it at the pump, and I think everybody who's driving around, whether you're a first-time car driver or a person who's had a car for a while, I think you're feeling it at the pump because it's really expensive. I used to fill my Volvo, I told you before off the air, Keith, back in 2015 with maybe $45. The other day, I put $75 and didn't even come to full.

Keith: Yeah, we looked at gasoline prices before the show over a 10-year period across the country. Let's say it averaged $1.20 a liter over the last five years, and now it's coming in around $1.40 to $1.60, some areas a little bit more expensive. So that's that 33% increase. In fact, during the lockdown of March and April of 2020, gasoline was at 80 cents a liter. Now, obviously, nobody was driving cars, and everybody was staying at home, but that's a big jump.

Marcelo: It is. It's huge. Let me ask you something. There's a very interesting number that the Federal Reserve publishes, and it's the implied 10-year rate for the expected inflation. So tell me more about that. We were talking about it off the air, but I think it's an interesting one for the expectations going forward. So tell me more about that.

Keith: Yeah. It's not necessarily published by the Fed, although the Fed does follow it. What essentially it is, people will say, let's look at the bond market and try to figure out what the bond market is telling us with regards to inflation. So there's a calculation called the 10-year implied or 10-year inflation rate, and what that is, they take the nominal 10-year. So today's nominal 10-year U.S. Treasury is 1.66%. And then they take the gap between that and the 10-year inflation-linked bond, which is trading at minus 0.95%. So you take the gap and then you calculate what the implied inflation rate is, and that gap today is suggesting that the implied rate is 2.6% for the next decade. Now, is that material? When you look at implied rates, if you go back to 2016, the implied rate was 1.5%.

Marcelo: I see.

Keith: So the difference between 1.5% and 2.6% is material. And that's a big number. So what's interesting about the implied rate is that when we did our first little show and we added inflation in July, Marcelo, the implied rate was 2.3%. So now it goes from 2.3% to almost 2.7%. And it's done that just in a matter of two months. So what that's saying is that the bond market is actually starting to worry a little bit more about inflation. It's starting to price in the fact that there's a little bit more coming. So you can see how quickly it moved from 2.3% to 2.7%. And we're not suggesting it's going to go from 2.7% to some dramatically different number, but it can change, I guess, is the point. And the bond market is saying that some things are coming down.

Marcelo: Yeah, it makes sense. It's just that way—everybody's pricing it today based on what we're seeing kind of thing, right?

Keith: Yeah. And of course, all this is technical. You talk about statistics, and most of the listeners are not tuning in and saying, "Okay, gee, what was the inflation rate last month?" And they don't follow CPI. These are sort of economic numbers. So we're starting the show off with a lot of these statistics and these points of interest from an economic perspective, and we're going to slide into more practical issues like how that affects people. Let's move to the why right now. So why is this occurring? What's happened in the past year that is pushing up inflation?

Marcelo: Of course, everybody knows we went through lockdowns, right? Everything was brought to a halt, and a lot of the supply operations were shut down. People were staying home, so there was less demand. All of a sudden, there were reopenings. We now have the vaccines, which are great because I think people are enjoying themselves now a bit more, and we are a bit more confident as to how we're dealing with the pandemic. But now, what happens on the economic side is that a lot of companies are trying to figure out this new supply dynamic where everybody's back to consuming and going out, and they're struggling to keep up with the demand. So essentially, there's a lot of money chasing few goods. Everybody knows about the chip shortage, which affects a lot of industries like the car industry, the oil industry, and that's essentially what's driving the prices up. Then on the other hand, you have labor shortages. So there's this weird dynamic where people are rethinking their work situation. They're getting money from the government. You've heard it, Keith. A lot of people are talking about not being able to find employees. I know a few business owners who've mentioned it to me. It is starting to sound like a very common thing in the labor market. So that's pushing the inflation problem a bit more because you have to up your wages to find workers. And a lot of companies just translate the price increases to the consumers, right?

Keith: Yeah. I started playing golf this year. It's my new activity. And there's a few guys that I golf with and women—my wife joined too. There's some business owners, and you do hear them talk about labor shortages, and they're having a hard time filling their employment structure because they just can't get people. People are making life decisions, and people are moving, and this pandemic has really affected the labor market. And so you add that to the supply chain, and you're right. You're absolutely right. That's what's affecting some of the underlying prices. So as we think about this, why is inflation destructive? Why do people worry about inflation?

Marcelo: Leaving the abstract definition, obviously, it pretty much affects your day-to-day purchasing power. If all of a sudden your money is worth less and you need the same things, and let's say your wages aren't going up, you're paying more for the same things that you needed yesterday or a year ago. That affects the way you live on a day-to-day basis.

Keith: Yeah, I like to think of inflation as the opposite of compound growth. In the financial world, we often talk about it as the eighth wonder of the world, which is this ability that over long periods of time, growth will have a massive impact positively in terms of the way your portfolio or anything grows. Exponential growth is a wonderful thing to have if it's something you're looking for. Inflation is a bit the opposite. It's this nemesis that kind of creeps in, stays there, and just doesn't leave. And then it can deteriorate your financial structure and your financial affairs. So that's why it's critical. Often, we hear about these stories about, Marcelo, what a can of Coke used to cost 30, 40 years ago, or a stamp, or milk. Just go over some of those numbers so that we can understand. Of course, this is 50-year inflation numbers, but the point is valid, right?

Marcelo: Milk was 10 cents for a liter in 1935, and now it costs $2.48. You mentioned a Coke—a can of Coke was a nickel in the 1950s, and now it costs roughly $2. Those are real examples. I think the movies are the same thing. You ask your parents how much it cost to go to the movies back in the 80s and 90s and what it costs now, and that's seen a huge increase. I have a personal story: I love barbecuing in the summer, right? I had a barbecue this summer with the same amount of people that I usually have, which is around six, seven people, and I always buy the same cuts of meat. In 2019, I paid roughly $160 for all the meat that I bought. In August of this year, I went to buy the same things, roughly the same amount. I paid $230. So that is a huge increase, and that's inflation right there.

Keith: Marcelo, I need to become invited somehow to those parties. That is good. That's a good cut of meat that you're serving. That's incredible. I know you're a foodie though. I know that you like barbecuing and treating your guests very well, but that's a heck of a story.

Marcelo: Yeah. If you're a vegan, you can zone out this part of the podcast, but yeah, I love my meat.

Keith: So this is the issue. And there's these abstract concepts that people hear about all the time, like what something cost 30 or 40 years ago. That's the abstract story, but it's real. And that is the compounding effect of inflation added up over time. And what we've seen in the last little bit, and I think what's interesting right now is we haven't seen high inflation for almost two decades—or higher inflation. And nobody's talking about inflation skyrocketing. There's a great article in this week's Globe and Mail, and it was written by Ian McGuigan, and he had a phrase in there that said, "This is not your daddy's inflation." And I thought it was really good because essentially he was saying, listen, there's a lot of discussion around inflation out there, but let's be real here. We're not talking about the inflation crisis that occurred in the 70s and 80s where you had inflation running at anywhere from 8 to 11%.

Marcelo: Yeah, that was crazy.

Keith: But that doesn't take away the negative impact that inflation can have running at 4%, which is very high. And then what most people are talking about it being at 3% for 2022 and 3% for 2023. I think perspective is important, and I think it's critical, but we have clearly gone through this period for the past decade where people just aren't used to living with inflation. They don't know what inflation is, and honestly, I think we're in for a bit of a wake-up call here.

Marcelo: Yeah, my consciousness of being a conscious consumer and an investor and getting serious about money—I've never experienced high inflation. For me, it's such a foreign concept. It's an academic concept that you study in university and you read about, but it's not something we've lived with for sure. At least my generation.

Keith: Absolutely. So what's the big debate, Marcelo? When we hear about central bankers—and this is what I find is confusing for anybody reading the newspapers—you open the newspaper one day, and you'll read Bank of Canada believes this. And then you open the newspaper the next day, and they'll say the Federal Reserve in the United States says this. And then you have bank chairmen coming in with different opinions. What are people debating here around inflation?

Marcelo: I think there's a big debate right now. It's almost like a clash between the central banks and the private industry or private sector. The IMF, the Bank of Canada, and the Fed are saying this is transitory. It's the bottlenecks of supply, and we're monitoring, but it is transitory and it's not here to stay. Whereas the executives at the biggest banks are saying, no, it may stay longer than the official sources are saying. So that's creating some confusion. I think the important thing to remember here, and I think you'll agree with me, Keith, is that we're dealing with an economic model here, and economic models for predicting inflation are just an abstraction of reality. So there's a lot of nuance in there. We often forget that the market has millions of participants with different motivations, incentives, and things are complicated to predict. And as good as these models are for creating expectations in consumers, they're not for sure.

Keith: And even opinions are changing. So you have U.S. bank CEOs—Jamie Dimon is talking about it being more transitory. So transitory again is this idea that we have inflation for a year or two, and then things taper off once the economy starts to settle down and we go back to that 1 or 2%. Jamie Dimon, a CEO in the United States, very well-known, very outspoken, calls it transitory. And then you've got Canadian bank CEOs in the past week or two raising the alarm bell saying that they think it is not transitory and that in fact it's here to stay a little bit longer. This is what's really confusing when you read all these different headline pieces. There are different opinions, and even the Bank of

Canada just came out and said, we thought it was transitory, but we're actually thinking it might be a little bit longer, but they're still in the transitory camp. So Marcelo, let's switch gears and go into implications of inflation for all of our listeners. We've got three areas that we're going to touch base on. We're going to talk about revenue implications, we'll talk about portfolio implications, and then we're going to talk about living implications. So let's start with your thoughts on revenue implications.

Marcelo: Yeah, so revenue implications—the Social Security in the U.S. just announced that it's going up 6% next year. Then OAS in Canada or any other pension that's inflation-adjusted will follow suit and will be going up as well. But if your source of revenue is not linked to inflation, you will see the consequences because now your budget will have to get adjusted. So I think those are the revenue implications.

Keith: You're absolutely right. It was amazing. I think it was a day or two after the U.S. announced it had 5% inflation, Social Security came out and said everyone's pension payment is going up by 6%. So if you're a pensioner in the United States, you saw your income go up by 6%. So you can still buy the things you've always been able to buy. And in Canada, as you mentioned, OAS and either in Quebec, Régie des rentes du Québec or the rest of Canada pension, those will be adjusted with inflation. And if you're fortunate enough to have the best type of pensions, which are pensions that are defined pensions—in other words, you get an income every year and that are linked to inflation—you're protected. Everybody else is not protected.

Marcelo: That's right. I mean, if you have a pension that's not adjusted for inflation, or you don't have a pension and you rely solely on your portfolio or any revenue that's not linked to inflation, then that becomes a bit tricky and you'll feel the implications of inflation being high.

Keith: Yeah. And it's one of these things where, again, we go back to this last 10 years, because I think that's the anchoring that people will do. They've never had to worry or think about this. So today we've got 4%, and let's say next year and the year after we get 3% and 3%. So that'll essentially mean if you compound that in three years from now, you need a 10% improvement in your income just to match the standard of living. In fact, it's even a bit more because it compounds. And that's a big bite. So that obviously has implications on portfolios as well, Marcelo. So what does that mean? What are your thoughts around that?

Marcelo: I think if you're relying on your portfolio to keep up with inflation so you can keep your standard of living, you're going to need your portfolio to outperform the levels of inflation. So at a bare minimum, if inflation is 4%, you need to be getting at least 4% or 5% at a baseline just so you can keep up with that inflation. Now, obviously, anything above that is amazing, but at least you've got to be able to keep up with it.

Keith: You're absolutely right. And I would even go as far as saying it has implications on things like how you think about portfolio construction and the difference between investing in fixed income and investing in equities. And I'll give you an example. Individuals investing in fixed income in the last two decades have gone from higher nominal rates, let's say 20 years ago, with inflation at 1 or 2%. So they've always managed to be able to produce returns on the fixed income side that were ahead of inflation. So you could have gotten the 4% and the 5% return with inflation at 2%. So you're getting 300 basis points of a real return. And in today's world, if inflation is 4% and a fixed income return is 2%, you are in the hole by 2%. And we haven't seen this before in a long time. And so the implications are, if you're going to build a portfolio, if you're a younger person and you're extremely conservative, you're running an uphill battle here because your portfolio will not grow. And growth in a portfolio is not, does it get the 2% or the 3% or the 4% of inflation? You invest ultimately to get more than inflation in a perfect world. There are periods where investors cannot get that. It's just not available in the marketplace. And we might be in for one of these periods right now on the fixed income side. Net of fees, net of tax, you can't get ahead of inflation. And that seems to be coming for the fixed income market. To me, that's a whole area where individuals are going to have to readjust their expectations of what a return should look like.

Marcelo: Yeah, I think that's the key word there: expectations. And any new person entering the market or any client worrying about keeping up with inflation, inherently, they're going to have to take more risk.

Keith: One of the areas on the equity side, and we spoke about this in our last show on inflation, but one of the nice things about investing in businesses is that often businesses get an opportunity to pass on their costs if they can. Just this week in the Globe and Mail, there was a survey of Canadian businesses, and most said they expect to increase their prices and the consumers will have to pay those prices. So that means that their profit margins are most likely protected. So if you want to protect your preservation of purchasing power over long periods of time, you need to be buying assets that will appreciate and have control over that inflation or have an opportunity to protect their ownership, their stakeholders. So that's why stocks have a tendency of doing better over longer periods of time. So the implications around the portfolio I think are important, Marcelo. It might mean that investors might have to take a little bit more risk in their portfolios. It might mean they have to make sure of high levels of diversification. They have to be very practical about if they're going to invest in fixed income, what is that going to return? And there's nothing wrong with investing in fixed income. If at the end of the day you still can't keep up with inflation, it might allow you to sleep very well at night, but you have to adjust your expectations in terms of how your portfolio will appreciate.

Marcelo: I just had the realization too that it's going to make financial planning and having a holistic plan even more important. Because right now, if you're just having a service where it's just investing and you don't even think about the other areas, you're doing a disservice to somebody. So you got to bring everything together to be able to know how much risk you need to be taking to at least keep up with inflation based on how much you're going to need to retire and that type of thing.

Keith: Absolutely. You bring up an amazing point. When we do the projections for clients, we obviously put in assumptions. And most of our assumptions right now are 2% for inflation, but we have growth, and that affects their purchasing power as well as that affects the price of their cost of living. But we will be able to make those adjustments and show clients what impact that will have and show investors. And so investors at large should be conscious of this. What about living implications, Marcelo? Let's end this episode with just how individuals might have to start living.

Marcelo: Yeah. I think a lot about my peers when it comes to this section because I think we're going to feel it, myself and my wife. I think everybody, but mostly the younger generation. If you recently bought a house and your heating costs are going up, your food items are going up, you have a mortgage to pay. So if you have high inflation now, if you have a mortgage that's variable and you're struggling to make those payments, that could affect you. So I think all those things, it's going to put a dent in people's budgets, and something's got to give. If you're spending a lot on lifestyle and you're still managing to save for retirement, now you're going to feel some pain in a few areas. So you're going to have to say, you know what, either I adjust my lifestyle, or I sacrifice my retirement, or I adjust my lifestyle and still save for retirement. So I think a lot of people are going to have to make choices, and budgeting is going to be a tricky thing now. And you're going to have to pay careful attention to how your money is spent.

Keith: I think you're absolutely right. I think what you're mentioning for the accumulators, the trade-off is going to be between lifestyle and savings. In our profession, we would say, make sure you pay yourself first, which means basically get your savings in place, which means the dent is on the lifestyle. Now the flip side, the other observation I would make is that, say we've gone through the pandemic. Obviously, the pandemic is not over, but we seem to be in an environment where things are improving. Economies are opening up. Just this week, the Canadian government announced that Canadians are okay to travel internationally. You shouldn't reserve it just for essential travel. So the good news is life is going to come back. And people are going to be, I think, overwhelmed with positive feelings, and it's going to be fun. What's happened essentially in this pandemic is a very odd financial circumstance. We've gone through a very difficult time. Financially, there's been a lot of improvements for individuals. They've seen their portfolios go up. They've seen their real estate go up. So average net worths are up 15 to 20%. For those that were fortunate enough to keep their jobs and work from home, they have never saved more before in their lives because they weren't spending, they were locked down. So saving rates were huge. So now we're coming out of all this, and now there's adjustments to make. And so we have gone through the positives on the financial side. And so this is definitely a headwind—higher prices—but the flip side is that hopefully the pandemic is more behind us than in front of us. And that's an incredibly positive thing. So your takeaway, Marcelo. Let's talk about a few takeaways here. One takeaway.

Marcelo: My takeaways are always boring, Keith, but my takeaway when I think about all this puzzle of inflation and all the implications that it has, say, on a young person or an accumulator or even a retiree, is know your plan. Make sure you know where your money is going. And when it comes to investing, make sure that you have the peace of mind that you are in the right portfolio to weather this inflation and that you're going to be okay in the long term. So I think short term, my takeaway is know where your expenses are going. I've told you before, I'm not a big fan of itemizing every spending item, but on the macro level, I like to know where the money is going type of thing. And then in the long term, make sure that your asset allocation and your investing is in sync with your retirement plan or your saving plan and that it makes sense for this new level of inflation that we're seeing.

Keith: Those are fantastic takeaways, Marcelo. They're not boring at all. They're practical, and they make absolute sense. What are you talking about? They're fantastic. The only thing I would say is keep perspective. We still don't know exactly how things will work. There's a lot of forecasts out there. We don't subscribe to buying into one or the other. Keep perspective, live within your means, and you're right. Stay tuned to your plan. Understand where you're going. Have a plan and understand where you're going, and make sure you test your plan with some of these inflation marks. So put a 3 or 4% in there, reduce your real returns a little bit, and see if you're okay. Make sure you're okay.

Marcelo: Yeah, I think as a baseline, if you have a projection, it's always better to be more conservative.

Keith: Absolutely. 100%.

Marcelo: Yeah.

Keith: Marcelo, thanks so much for joining us. It started off as a bit of a technical episode on inflation and where we're at, but there are some real-life implications here, and we wanted to do this update. We did a piece on inflation a couple of months ago. Listeners, we hope that you found that informative and helpful. And until next time, thanks so much and see you soon.

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